Before the
Federal Communications Commission
Washington, D.C. 20554

CC Docket No. 93-179

In the Matter of

Price Cap Regulation of
Local Exchange Carriers

Rate of Return Sharing
And Lower Formula Adjustment

NOTICE OF PROPOSED RULEMAKING

Adopted: June 18, 1993; Released: July 6, 1993

Comment Date: August 2, 1993
Reply Date: September 1, 1993

By the Commission:

I. INTRODUCTION AND SUMMARY

1. Under the Commission's price cap plan, a local exchange carrier's (LEC's) interstate rate of return in one year can be the basis for adjustments to that carrier's price cap indexes in the following year. This rate of return "backstop" is intended to tailor the plan to the circumstances of individual LECs, while assuring that customers share in productivity gains. In order to preserve the efficiency incentives of price caps, this adjustment to the indexes applies only to the next year's allowable rates, and only if the LEC's rate of return falls outside a broad range around the rate of return used to begin LEC price caps, 11.25 percent. The LEC generally begins to share half of its earnings with customers beginning at a 12.25 percent rate of return; all earnings above 16.25 percent are returned to customers through this adjustment. Similarly, at the low end, if the LEC's earnings fall below 10.25 percent, an upward adjustment in the price cap indexes is permitted in the following year.

2. LEC price cap rates took effect on January 1, 1991, and the first application of this sharing and lower adjustment mechanism occurred in the annual 1992 access tariff filings, which were filed in April 1992 and took effect on July 1, 1992. LECs with rates of return above 12.25 percent during 1991 lowered their price cap indexes by a total of $76.8 million to share earnings. LECs with rates of return below 10.25 percent increased their indexes by a total of $96.6 million.

3. In the annual 1993 access tariff filings, an issue has arisen as to how such sharing and lower end adjustments to the price cap indexes should be reflected in the rate of return used to determine sharing and lower formula adjustments in the following year. Some price cap LECs have proposed that the rate of return used to compute this year's backstop adjustments should include the effects of last year's backstop adjustment. This approach would reduce sharing amounts this year for LECs who were subject to sharing last year. However, under rate of return regulation we have required LECs to "add-back" an adjustment for rate of return-based refunds from prior periods. "Add-back" would also increase the lower end adjustment, and thus permit higher rates, for LECs who received that adjustment last year.

4. Our review of the LEC price cap plan, and the rules and orders implementing it, indicates to us that the amounts of the backstop adjustments should probably not be included when computing the rates of return used to determine sharing and lower end adjustments in the following year. As we discuss below, we believe that "add-back" is more consistent with the price cap plan as it was adopted. However, we recognize that this issue was neither expressly discussed in the LEC price cap orders nor clearly addressed in our Rules. "Add-back" also poses implementation issues that it may be useful to air and resolve now that the first tariffs raising this issue are before us. Accordingly, we are establishing this docket to seek comment on the tentative conclusion discussed below, and on proposed rule changes, to incorporate "add-back" clearly into the LEC price cap rules.

II. DISCUSSION

A. Add-Back In Rate of Return Regulation

5. Under rate of return regulation, LECs refund overearnings above the prescribed maximum allowable rate of return, whether through direct payments to customers, rate reductions in a subsequent tariff filing period, or damages awarded after complaints. Because the rate of return prescription applies to a LEC's performance and rates within a specific monitoring period, we have required LECs to treat refund payments as adjustments to the period in which the overearnings occurred, rather than to the period in which the refund is paid.[1]

6. This approach is implemented by including a line-item on the rate of return monitoring report, Form 492, which displays the amount of refunds associated with prior enforcement periods.[2] The refunds are then "added back" into the total returns used to compute the rate of return for the current enforcement period.[3] The net rate of return after add-back is then used to determine compliance with the prescribed rate of return during the new enforcement period, and to compute the amount of any refund obligation.[4]

1 Amendment of Part 65, Interstate Rate of Return Prescription: Procedures and Methodologies to Establish Reporting Requirements, CC Docket No. 86-127, 1 FCC Rcd 952, 956-57 (1986).
2 *Id.* at 960-961, Appendix C.
3 Section 65.600 of the Commission's Rules, 47 C.F.R. Section 65.600.
4 Sections 65.700-03 of the Commission's Rules, 47 C.F.R. Section 65.700-03.

B. The Rate of Return Backstop in the LEC Price Cap Plan

7. A pure price cap plan seeks to establish reasonable rates by capping prices rather than profits. For example, in our AT&T price cap plan maximum prices are limited by a formula that adjusts the price cap indexes (PCIs) annually based on inflation and a productivity target, not the carrier's own costs.[5] The Commission was concerned, however, that a pure price cap plan might produce unintended results as applied to the many individual LECs and their varying operational and economic circumstances.[6] For this reason, the Commission included a rate of return-based backstop mechanism in the LEC price cap plan. The plan retains productivity incentives by allowing LEC earnings to vary within a wide range around the initial 11.25 percent rate of return. Outside that range, the sharing and lower formula adjustment apply to adjust the price cap index.[7]

8. We anticipated that the backstop would operate in much the same way as rate of return enforcement for LECs still subject to rate of return regulation. Rates of return would continue to be calculated and reported in essentially the same manner.[8] Where we found that changes in the application of the rate of return were appropriate, we specifically adopted them. These changes included the wider range of earnings, the exclusion of the LEC price cap earnings thresholds from the rate of return represcription process, and the deletion from earnings reports of information not needed under the price cap plan.[9]

9. We adopted the sharing and lower end adjustment mechanisms both as rules and prescriptions, similar to the prescription applied to rate of return carriers.[10] We also made clear that we expected the mechanisms to enforce the earnings limits we had adopted, in order to assure that rates would remain within a range of reasonableness, and that particular LECs could not retain unusually high earnings that were not necessarily tied to increases in productivity. Section 61.45(d)(2) requires that price cap LECs "shall make such temporary exogenous cost changes as may be necessary to reduce PCIs to give full effect to any sharing of base period earnings required by the sharing mechanism...." *See also* Section 61.45(d)(1)(vii).

C. The Add-Back Issue for the Price Cap Backstop

10. Our initial review of the record does not indicate that any commenters in the LEC Price Cap rulemaking or in the subsequent reconsideration proceeding discussed the details of rate of return calculations, or requested that we eliminate add-back from the rate of return calculations of the LEC price cap plan. In discussing and adopting changes in rate of return monitoring and reporting, we also did not indicate that the add-back provisions in Form 492, which is used to report returns, were to be changed.

11. We have also examined the effects of add-back and believe that it continues to be an appropriate and indeed probably necessary component of the backstop. First, as we discussed in the *LEC Price Cap Order,* the price cap plan is intended to create incentives for productivity growth. Changes in rate of return each year are used as a measure of productivity growth relative to the price cap target. The amounts of sharing or lower formula adjustment implemented in one year, however, relate to productivity performance in a prior year. Thus, unless add-back occurs, the relationship between rate of return and productivity growth becomes hidden.

12. Second, without add-back, artificial swings in earnings can occur. As the example in Appendix A illustrates, the use of unadjusted rates of return for backstop calculations create a "see-saw" effect on earnings, even if the carrier's operational performance was the same each year. This can occur because the unadjusted rate of return effectively double-counts the amount of the backstop adjustment, once in the base year and then again in the tariff year.

13. Third and most important, add-back appears necessary to the rate of return thresholds applied to determine price cap LECs' sharing obligations and lower adjustment right are those we intended. The price cap plan gives the LECs substantial flexibility in their rates and earnings, to encourage greater efficiency. However, for the LECs the Commission established limits on this flexibility and a range of reasonableness for LEC earnings. Without add-back, the double-counting of backstop adjustments could effectively permit earnings outside the range of reasonableness we designated. LECs would share less of their earnings as they approach or exceed the high end of the range, and would receive smaller adjustments when they fell below the low end of the range. In both cases, the effective rate of return over time could fall outside the range of returns we judged to be reasonable. Rates of return would not be limited to the 16.25 percent maximum we established for LECs electing a 3.3 percent productivity factor, nor would earnings below 10.25 percent be adjusted upward to 10.25 percent. This effect is illustrated in the examples in Appendix A. The examples also show that this discrepancy could be quite significant. In the current annual access tariff filings, use of the unadjusted rate of return for computing this year's backstop adjustments would permit rates of return that would be on average 0.2 percent higher at the upper end, and 0.5 percent lower at the low end than the adjusted rate of return. For individual LECs, the effect is often greater still, as much as 2.0 percent above and 0.9 percent below the rate of return calculated without the adjustment.[11] The add-back adjustment corrects these deviations and sets the backstop rate of return limits at the levels we selected in the *LEC Price Cap Order.*

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5 Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, 2922-33 (paras. 100-114) (1989) (*AT&T Price Cap Order);* Erratum, 4 FCC Rcd 3379 (1989).

6 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786, 6801 (1990) (*LEC Price Cap Order*).

7 For LECs who elect a productivity factor of 3.3 percent during the tariff year, the 50 percent sharing obligation begins for rates of return above 12.25 percent and 100 percent sharing begins at 16.25 percent. For LECs who elect the more challenging 4.3 percent productivity factor, 50 percent sharing begins for rates of return above 13.25 percent, and 100 percent sharing begins at 17.25 percent. The lower formula adjustment remains at 10.25 percent in both cases. *LEC Price Cap Order,* 5 FCC Rcd at 6787-88 (paras. 7-10).

8 *LEC Price Cap Order,* 5 FCC Rcd at 6832 (para. 373).

9 *LEC Price Cap Order,* 5 FCC Rcd at 6827-34 (paras. 332-84).

10 *LEC Price Cap Order* at 6836 (paras. 403--04).

11 For example, in the annual 1992 access tariff filing, Ameritech calculated a sharing obligation of $18.2 million and reduced its rates on July 1, 1992 to return that amount to ratepayers. Thus, Ameritech's revenues were about $9.1 million lower in 1992 that they would have been without sharing during the second half of the year. Ameritech reported its rate of

14. By reducing the range of earnings permitted under the backstop, however, add-back does reduce the efficiency incentives. Moreover, to the extent that the sharing and lower end adjustments under price caps are not refunds, it might be argued that the rate of return methodology used to define sharing obligations and lower formula adjustments should be based upon the returns achieved under the rates actually charged during the base year.

15. Based upon our review of this issue, we tentatively conclude that the add-back adjustment should continue to be part of the rate of return calculations of LECs subject to price caps, preceding their calculations for purposes of the backstop sharing and lower formula adjustments. We propose specific rule language in Appendix B to implement this tentative conclusion. We also request comments on this tentative conclusion and other mechanisms to deal with the issues we have discussed.

D. Credit for Below-Cap Rates

16. Use of add-back would present at least one further issue: whether a LEC that has set its rates below the price cap indexes during the base year should receive credit for the amount between its PCI and its API, or actual prices, in calculating its sharing amounts. In a sense, the LEC has already passed through some rate reductions by pricing below the cap. Allowing credit for below-cap rates would encourage carriers to charge lower, below-cap rates. Conversely, if the LEC's low earnings in one year are in part the result of its own decision to set rates below the cap, the rationale for allowing an upward adjustment in the cap the next year would seem to be less persuasive. Moreover, we established the alternative 4.3 percent productivity factor as an option for LECs who are willing to make larger up-front rate cuts in exchange for reduced sharing requirements. We did not specify other adjustments to sharing obligations, and declined to adopt a plan that would have automatically reduced sharing based upon the actual rates set by the LEC.[12] We request comment on whether LECs should be given credit for below-cap rates in the price cap backstop mechanism and how such a credit would be calculated.

III. PROCEDURAL MATTERS

17. *Regulatory Flexibility Act.* We certify that the Regulatory Flexibility Act of 1980 does not apply to this rule making proceeding because if the proposed rule amendments are promulgated, there will not be a significant economic impact on a substantial number of small business entities, as defined by Section 601(3) of the Regulatory Flexibility Act. Local exchange carriers subject to price cap regulation, who would be affected by the proposed rule amendments, generally are large corporations or affiliates of such corporations. The Secretary shall send a copy of this Notice of Proposed Rule Making, including the certification, to the Chief Counsel for Advocacy of the Small Business Administration in accordance with paragraph 6503(a) of the Regulatory Flexibility Act. Pub. L. No. 96-354, 94 Stat. 1164, 5 U.S.C. Section 601 *et seq.* (1981).

18. *Comment Dates:* Pursuant to applicable procedures set forth in Sections 1.415 and 1.419 of the Commission's Rules, 47 C.F.R. Sections 1.415 and 1.419, interested parties may file comments on or before **August 2, 1993** and reply comments on or before **September 1, 1993**. To file formally in this proceeding, you must file an original and four copies of all comments, reply comments, and supporting comments. If you want each Commissioner to receive a personal copy of your comments, you should file an original plus nine copies. You should send comments and reply comments to Office of the Secretary, Federal Communications Commission, Washington, D.C. 20554. Comments and reply comments will be available for public inspection during regular business hours in the FCC Reference Center, Room 230, 1919 M Street, N.W., Washington, D.C. 20554.

19. *Ex Parte Rules - Non-Restricted Proceeding.* This is a non-restricted notice and comment rulemaking proceeding. *Ex parte* presentations are permitted, except during the Sunshine Agenda period, provided they are disclosed as provided in Commission Rules. *See generally* 47 C.F.R. Sections 1.1202, 1.1203, and 1.1206(a).

For further information on this proceeding contact Dan Grosh, Tariff Division, (202) 632-6387.

FEDERAL COMMUNICATIONS COMMISSION

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return for 1992 at 12.79 percent without add-back. An add-back adjustment of $9.1 million, along with the federal income tax effect, would raise Ameritech's rate of return to 12.99 percent. This 0.2 percent difference in rate of return would generate an additional $3 million in sharing obligation during the access year beginning on July 1, 1993.

Conversely, Contel of the South, which had a low end adjustment in 1992 of $3 million, reported a rate of return before add-back of 8.63 percent in 1992. With add-back, its adjusted 1992 rate of return would be 8.15 percent. Use of the adjusted rate of return in the low end adjustment would permit an additional $1 million in low end adjustment for Contel in the forthcoming access year.

12 *LEC Price Cap Order,* 5 FCC Rcd at 6803 (paras. 138-39).

APPENDIX A

- Consider the company whose earnings are as shown below, which makes its refunds through a refund check each December 31

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,425	2,425	2,425
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25	14.25	14.25	14.25
Refund	100	100	100	100
ROR with Refund	13.25	13.25	13.25	13.25

- Contrast this with the effect on this same company with a sharing plan to implement the refunds, but without an add-back

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,325	2,375	2,350
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25	13.25	13.75	13.50
Sharing to be returned in next year	100	50	75	62.50

  - This company shares less and reports a different rate of return each year, even though its underlying costs did not change

- Contrast this result with the effect of including the add-back

	Year 1	Year 2	Year 3	Year 4
Revenues	2,425	2,325	2,325	2,325
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	14.25	13.25	13.25	13.25
Add-back	0	100	100	100
ROR with Add-back	14.25	14.25	14.25	14.25
Sharing	100	100	100	100

- Thus the company which includes the add-back in its rate of return computation has the same rate of return and returns the same amount of money to ratepayers as the company which makes its refund by a check.

- Consider the company whose earnings are as shown below, which receives its low-end adjustment through a check each December 31

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	1,925	1,925	1,925
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	9.25	9.25	9.25
LowEnd Adj	100	100	100	100
ROR with Adj	10.25	10.25	10.25	10.25

- Contrast this with the effect on this same company with an exogenous adjustment to implement the low end adjustments, but without an add-back

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	2,025	1,925	2,025
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	10.25	9.25	10.25
Low End Adj to be re-gained in next year	100	0	100	0

  - This company receives less low end adjustment and reports a different rate of return each year, even though its underlying costs did not change

- Contrast this result with the effect of including the add-back

	Year 1	Year 2	Year 3	Year 4
Revenues	1,925	2,025	2,025	2,025
Expenses	1,000	1,000	1,000	1,000
Rate Base	10,000	10,000	10,000	10,000
ROR	9.25	10.25	10.25	10.25
Add-back	0	-100	-100	-100
ROR with Add-back	9.25	9.25	9.25	9.25
LowEnd Adj	100	100	100	100

- Thus the company which includes the add-back in its rate of return computation has the same rate of return and receives the same amount of money as the company which receives its low end adjustment in a check.

APPENDIX B

Proposed Rule Section

Part 61 of Title 47 of the Code of Federal Regulations is proposed to be amended as follows: 1. The authority citation for Part 61 continues to read as follows:

AUTHORITY: Sec. 4, 48 Stat. 1066, as amended; 47 U.S.C. 154. Interpret or apply sec. 203, 48 Stat. 1070; 47 U.S.C. 203.

2. Section 61.3(e) is revised by adding the following bracketed language: Section 61.3 **Definitions**

(e) **Base Period.** The 12 month period ending six months prior to the effective date of annual price cap tariffs. [Base year or base period earnings shall not include amounts associated with exogenous adjustments to the PCI for the sharing or lower formula adjustment mechanisms.]